

RE:CM

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\_REGARDING CAPITAL MANAGEMENT

## INVESTING AS UNUSUAL

***“Investment is most intelligent when it is most businesslike”***, Benjamin Graham, Security Analysis, 1934.

At RE:CM we say that “...we value listed companies as a **businessman** would”.

Not many people understand what it really means to invest like a businessman would. Many professionals that make a living determining the value of all kinds of assets do not and might never know what it takes to produce an income stream from an asset (i.e. running a successful business). All they care about is management’s latest ‘guidance’ on immediate earnings prospects!

Think about a cabdriver contemplating buying a new cab. The cabbie will (hopefully!) figure out what it costs versus what it will earn him. To him the cab is not just a vehicle, it’s a business. The value of his investment in the cab is not determined by earnings prospects over the next 12 months; it is lifetime earnings that count. This is the way that we look at stocks.

Let’s explore some investment principles that help promote the **right mindset**.

A businessman would look at the security of his capital and the reward that he will get in return for the risk he is taking with his own money. The reward for taking risk should always be measured against an opportunity set: Money in the bank is relatively safe (depending on the bank) and rewards you with an appropriate risk free rate of return.

There are several ways of defining this ‘reward’. The starting point is to simplify the financial statements away from accounting speak into business speak: there is a world of difference between the accounting profits and the real hard cash that is available for shareholders. A business investor will focus on the cash return on his investment, which is the only way that he can be rewarded. It is usually very difficult to sell his investment to someone else, at least not until it generates good returns (and then why would he sell it?).

The measure of successful investment is the cash return on investment (in business speak the free cash flow). A portion can be paid out to shareholders, but paying a dividend is not easy; it takes strong financial discipline and can only be done after free cash is generated. Most public and private companies gear themselves up during the year due to funding working capital or

contractual expenses and select a financial year end that coincides with the strongest possible snapshot of their bank balances. Therefore balance sheet cash is not necessarily free cash!

When we value a company we look at the ability to generate a sustainable through the business cycle return on the capital invested by shareholders and the conversion (management) of that ability to profits and real cash. We make sensible and conservative long-term assumptions about that ability to assist in forming our estimate of the intrinsic value.

This does not mean that we only invest in dividend paying companies. We are concerned with the **ability** to pay dividends, or free cash flow. If the company is re-investing in organic growth and we are happy that returns are appropriate paying a dividend might be the wrong thing to do.

We think about the economics of ownership of the underlying businesses that our investment in the publicly traded equities represent. Making business sense means getting the highest annual compounding return possible with the least amount of risk. We only invest if we have a good understanding of the economics of a particular business. When this is combined with management that we trust to execute that economic scenario we will invest even more.

Consider two of the companies that we are invested with: Omnia and Rainbow Chicken (See the charts on page 3).

**Omnia** is a 50 year old company managing fertiliser, explosives and specialty chemicals businesses. In the 2001 financial year the company experienced an extraordinary margin squeeze due to external international events, something that has only happened once in the companies' lifetime. The collective market completely misunderstood the situation and sold the shares down to 300cps when the net asset value was 812cps. Even in that depressed year the company managed to generate free cash flow of 240cps (86cps the year before). An astute investor applying the business investment principles we have outlined above would have realised that this was the bargain of the century. A year later they paid a dividend of 81cps and two years later 120cps, an astonishing 40% yield on the original price. Today Omnia is trading at 2200cps and we continue to believe it is trading well below its intrinsic value.

The poultry industry in South Africa barely survived being targeted as a dumping ground for international excess chicken portions in the late 1990's. As a result of this and other internal factors **Rainbow Chicken** shares were trading at between 70-100cps for over a year in 1999/2000 when the replacement value of the hard assets in the ground was 5 times as much and it was generating free cash flow of around 30cps yearly compared to accounting earnings of -5cps in 1999 and 8.5cps in 2000. Even after the government introduced anti-dumping tariffs it took three financial years of solid results for the market to begin to realise that there is value in the share price. The share continued to trade at a substantial discount to net asset value until late in 2002! In the 2003 financial year the company generated 132cps in free cash flow. In our view it is still trading below its intrinsic value.

